

Fundamentals Level – Skills Module

# Audit and Assurance (International)

Wednesday 8 June 2011

**Time allowed**

Reading and planning: 15 minutes

Writing: 3 hours

ALL FIVE questions are compulsory and MUST be attempted.

**Do NOT open this paper until instructed by the supervisor.**

**During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.**

**This question paper must not be removed from the examination hall.**

The Association of Chartered Certified Accountants

# Paper F8 (INT)

The ACCA logo consists of the letters 'ACCA' in a bold, white, sans-serif font, centered within a solid black square.

**ALL FIVE questions are compulsory and MUST be attempted**

**1 Introduction**

Tinkerbell Toys Co (Tinkerbell) is a manufacturer of children's building block toys; they have been trading for over 35 years and they sell to a wide variety of customers including large and small toy retailers across the country. The company's year end is 31 May 2011.

The company has a large manufacturing plant, four large warehouses and a head office. Upon manufacture, the toys are stored in one of the warehouses until they are despatched to customers. The company does not have an internal audit department.

**Sales ordering, goods despatched and invoicing**

Each customer has a unique customer account number and this is used to enter sales orders when they are received in writing from customers. The orders are entered by an order clerk and the system automatically checks that the goods are available and that the order will not take the customer over their credit limit. For new customers, a sales manager completes a credit application; this is checked through a credit agency and a credit limit entered into the system by the credit controller. The company has a price list, which is updated twice a year. Larger customers are entitled to a discount; this is agreed by the sales director and set up within the customer master file.

Once the order is entered an acceptance is automatically sent to the customer by mail/email confirming the goods ordered and a likely despatch date. The order is then sorted by address of customer. The warehouse closest to the customer receives the order electronically and a despatch list and sequentially numbered goods despatch notes (GDNs) are automatically generated. The warehouse team pack the goods from the despatch list and, before they are sent out, a second member of the team double checks the despatch list to the GDN, which accompanies the goods.

Once despatched, a copy of the GDN is sent to the accounts team at head office and a sequentially numbered sales invoice is raised and checked to the GDN. Periodically a computer sequence check is performed for any missing sales invoice numbers.

**Fraud**

During the year a material fraud was uncovered. It involved cash/cheque receipts from customers being diverted into employees' personal accounts. In order to cover up the fraud, receipts from subsequent unrelated customers would then be recorded against the earlier outstanding receivable balances and this cycle of fraud would continue.

The fraud occurred because two members of staff 'who were related' colluded. One processed cash receipts and prepared the weekly bank reconciliation; the other employee recorded customer receipts in the sales ledger. An unrelated sales ledger clerk was supposed to send out monthly customer statements but this was not performed. The bank reconciliations each had a small unreconciled amount but no-one reviewed the reconciliations after they were prepared. The fraud was only uncovered when the two employees went on holiday at the same time and it was discovered that cash receipts from different customers were being applied to older receivable balances to hide the earlier sums stolen.

**Required:**

- (a) Recommend SIX tests of controls the auditor would normally carry out on the sales system of Tinkerbell, and explain the objective for each test. (12 marks)**
- (b) Describe substantive procedures the auditor should perform to confirm Tinkerbell's year-end receivables balance. (8 marks)**
- (c) Identify and explain controls Tinkerbell should implement to reduce the risk of fraud occurring again and, for each control, describe how it would mitigate the risk. (6 marks)**
- (d) Describe substantive procedures the auditor should perform to confirm Tinkerbell's revenue. (4 marks)**

**(30 marks)**

- 2 (a) Auditors are required to document their understanding of the client's internal controls. There are various options available for recording the internal control system. Two of these options are narrative notes and internal control questionnaires.

**Required:**

**Describe the advantages and disadvantages to the auditor of narrative notes and internal control questionnaires as methods for documenting the system.** (6 marks)

- (b) ISA 210 *Agreeing the Terms of Audit Engagements* provides guidance on the content of engagement letters and deals with the auditor's responsibilities in agreeing the terms of the audit engagement with management.

**Required:**

(i) **State the purpose of an engagement letter.** (1 mark)

(ii) **List SIX matters that should be included within an audit engagement letter.** (3 marks)

**(10 marks)**

- 3 (a) The auditor has a responsibility to design audit procedures to obtain sufficient and appropriate evidence. There are various audit procedures for obtaining evidence, such as external confirmation.

**Required:**

**Apart from external confirmation:**

- (i) **State and explain FIVE procedures for obtaining evidence and;**  
(ii) **For each procedure, describe an example relevant to the audit of purchases and other expenses.**

(10 marks)

- (b) Donald Co operates an airline business. The company's year end is 31 July 2011.

You are the audit senior and you have started planning the audit. Your manager has asked you to have a meeting with the client and to identify any relevant audit risks so that the audit plan can be completed. From your meeting you ascertain the following:

In order to expand their flight network, Donald Co will need to acquire more airplanes; they have placed orders for another six planes at an estimated total cost of \$20m and the company is not sure whether these planes will be received by the year end. In addition the company has spent an estimated \$15m on refurbishing their existing planes. In order to fund the expansion Donald Co has applied for a loan of \$25m. It has yet to hear from the bank as to whether it will lend them the money.

The company receives bookings from travel agents as well as directly via their website. The travel agents are given a 90-day credit period to pay Donald Co, however, due to difficult trading conditions a number of the receivables are struggling to pay. The website was launched in 2010 and has consistently encountered difficulties with customer complaints that tickets have been booked and paid for online but Donald Co has no record of them and hence has sold the seat to another customer.

Donald Co used to sell tickets via a large call centre located near to their head office. However, in May they closed it down and made the large workforce redundant.

**Required:**

**Using the information provided, describe FIVE audit risks and explain the auditor's response to each risk in planning the audit of Donald Co.**

(10 marks)

**(20 marks)**

- 4 You are an audit manager in NAB & Co, a large audit firm which specialises in the audit of retailers. The firm currently audits Goofy Co, a food retailer, but Goofy Co's main competitor, Mickey Co, has approached the audit firm to act as auditors. Both companies are highly competitive and Goofy Co is concerned that if NAB & Co audits both companies then confidential information could pass across to Mickey Co.

**Required:**

- (a) Explain the safeguards that your firm should implement to ensure that this conflict of interest is properly managed.** (4 marks)

Goofy Co's year end is 31 December, which is traditionally a busy time for NAB & Co. Goofy Co currently has an internal audit department of five employees but they have struggled to undertake the variety and extent of work required by the company, hence Goofy Co is considering whether to recruit to expand the department or to outsource the internal audit department. If outsourced, Goofy Co would require a team to undertake monthly visits to test controls at the various shops across the country, and to perform ad hoc operational reviews at shops and head office.

Goofy Co is considering using NAB & Co to provide the internal audit services as well as remain as external auditors.

**Required:**

- (b) Discuss the advantages and disadvantages to both Goofy Co and NAB & Co of outsourcing their internal audit department.** (10 marks)

- (c)** The audit engagement partner for Goofy Co has been in place for approximately six years and her son has just accepted a job offer from Goofy Co as a sales manager; this role would entitle him to shares in Goofy Co as part of his remuneration package. If NAB & Co is appointed as internal as well as external auditors, then Goofy Co has suggested that the external audit fee should be renegotiated with at least 20% of the fee being based on the profit after tax of the company as they feel that this will align the interests of NAB & Co and Goofy Co.

**Required:**

**From the information in (c) explain the ethical threats which may affect the independence of NAB & Co in respect of the audit of Goofy Co, and for each threat explain how it may be reduced.** (6 marks)

**(20 marks)**

- 5 You are the audit manager of Daffy & Co and you are briefing your team on the approach to adopt in undertaking the review and finalisation stage of the audit. In particular, your audit senior is unsure about the steps to take in relation to uncorrected misstatements.

During the audit of Minnie Co the following uncorrected misstatement has been noted.

The property balance was revalued during the year by an independent expert valuer and an error was made in relation to the assumptions provided to the valuer.

**Required:**

- (a) **Explain the term 'misstatement' and describe the auditor's responsibility in relation to misstatements.**  
(4 marks)
- (b) **Describe the factors Daffy & Co should consider when placing reliance on the work of the independent valuer.**  
(4 marks)
- (c) The following additional issues have arisen during the course of the audit of Minnie Co. Profit before tax is \$10m.
- (i) Depreciation has been calculated on the total of land and buildings. In previous years it has only been charged on buildings. Total depreciation is \$2.5m and the element charged to land only is \$0.7m.  
(4 marks)
  - (ii) Minnie Co's computerised wages program is backed up daily, however for a period of two months the wages records and the back-ups have been corrupted, and therefore cannot be accessed. Wages and salaries for these two months are \$1.1m.  
(4 marks)
  - (iii) Minnie Co's main competitor has filed a lawsuit for \$5m against them alleging a breach of copyright; this case is ongoing and will not be resolved prior to the audit report being signed. The matter is correctly disclosed as a contingent liability.  
(4 marks)

**Required:**

**Discuss each of these issues and describe the impact on the audit report if the above issues remain unresolved.**

**Note:** The mark allocation is shown against each of the three issues above. Audit report extracts are NOT required.

**(20 marks)**

**End of Question Paper**